

Revoke Rating Agencies' NRSRO Designation for Structured Products

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by [Janet Tavakoli](#)

The IMF invited me to present my views on the global financial crisis as detailed in my book, [Dear Mr. Buffett: What an Investor Learns 1,269 Miles from Wall Street](#) on Monday, September 21. Among other recommendations, I will suggest Congress approve more funding for investigations that should lead to felony indictments of financial professionals involved in the largest Ponzi scheme in the history of the capital markets. Predatory securitizations of fraudulent loans, the credit derivatives that referenced them, and fraudulent accounting enabled former investment banks and some legacy banks to raise money from new investors to pay back old investors (themselves and mortgage lenders) in what was known to be an unsustainable and fraud riddled business model.

The rating agencies have been in the news as they fend off lawsuits for their ratings of ABS CDOs (collateralized debt obligations backed by asset backed securities). The rating agencies claim their ratings are protected by free speech, and they may or may not be successful in defending themselves in court. In my book, [Structured Finance](#), I explain the rating agencies' history of failure (in my opinion) to competently rate hundreds of billions of dollars worth of these and other structured products. The relevant rating agencies involved in these ratings are the top three: Moody's Corporation; Standard & Poor's (S&P), part of McGraw-Hill Cos., inc.; and Fitch, owned by France-based Fimalac SA.

The rating agencies are quick to point out that they do not perform due diligence on the data they use and take no responsibility for unearthing fraud; they merely issue "opinions." But rating agencies can demand to see evidence of appropriate due diligence from the underwriters, who are obliged to perform it. Instead, rating agencies failed to adhere to basic statistical principles.

Meanwhile, the SEC [seeks comments](#) about the steps it should take to regulate the rating agencies. In [my letter to the SEC dated February 13, 2007](#), I called for the SEC to revoke the rating agencies' registration as Nationally Recognized Statistical Rating Organizations (NRSRO) for structured products. The SEC failed to act in 2007, but it can correct that error and do it now.

In addition to criticizing rating agencies for their ratings of CDOs, I mentioned another class of structured products, CPDOs that were rated "AAA" at the time I wrote the letter. I asserted CPDOs had substantial principal risk. That meant these "AAA" rated products deserved a junk rating. By January 2008, within a year of my warning, Moody's noted that two of the originally AAA-rated CPDO's would unwind causing substantial principal loss to investors. In fact Moody's, the rating agency that bases its "AAA" rating on expected loss, belatedly projected investors would have a *90 percent loss*. Although I had flagged the looming danger to investors' principal, the SEC did nothing.

NRSRO Grades, Not Mere Opinions

The problem with rating agencies' assertion that they issue mere opinions is that the NRSRO designation gives ratings the appearance of being issued from a position of authority. Regulators rely on this pseudo-authority so much that they have enacted capital rules for banks based on ratings. Many investment funds and investors have charters requiring them to only buy products that have been rated by one or more of the top three rating agencies. Ratings are relied upon as if they are based on reliable and reproducible methods, but they are not when it comes to structured products.

If the FDA approved tainted meat that sickened people, we would demand a top to bottom overhaul of the organization and its methods. Since the rating agencies issued ratings that contributed to massive damage to our economy, we should strip them of their NRSRO designation and demand a complete overhaul of their flawed procedures and methodologies.

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